

BEFORE THE STATE **BOARD** OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
AIRWAYS COMPRESSOR COMPANY, INC.)

For Appellant:	Arnold C. Libman Certified Public Accountant
For Respondent:	Jeffrey M. Vesely Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Airways Compressor Company, Inc., against a proposed assessment of additional franchise tax in the amount of \$955.00 for the income year ended October 31, 1973.

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The sole issue for resolution is whether appellant has satisfied its burden of proving that respondent's determination is incorrect.

Appellant is a California corporation which began doing business here in 1969. Its principal business is manufacturing and repairing air compressors for dentists and auto repair shops. It conducts its business entirely in California and has no other corporations affiliated with it.

On its California franchise tax return for the income year ended October 31, 1973, appellant credited **\$13,811.62** to its "unappropriated retained earnings," thereby increasing the earnings by that amount for the 1973 income year. The entry was labeled an "inventory adjustment" on Schedule M-2 and was in addition to the \$230.11 entry on Schedule M-2 for "net income per books." The effect of appellant's "inventory adjustment" was to increase inventory which, in turn, should have decreased cost of goods sold, thereby increasing net income. However, a review of appellant's "net income before state adjustments" shown on line 28 of the franchise tax return and its reconciliation with the "net income per books" reflected in Schedule M-1 indicates that the **\$13,811.62** "inventory adjustment" was not included within the computation of the cost of goods sold. Since the "inventory adjustment" was not included in the computation of cost of goods sold, appellant's determination of net income subject to the franchise tax for the year ended October 31, 1973, was understated by an equivalent amount.

During the course of an audit respondent inquired about the "inventory adjustment." Appellant stated that it had incorrectly labeled the adjustment on the return and that, in reality, it was the recovery of a bad debt. Appellant explained that it had merely debited accounts receivable and credited retained earnings by the **\$13,811.62** in 1973 at which time an account previously believed to be uncollectible became collectible. In a prior period, appellant contended that it had made the opposite entry (crediting accounts receivable and debiting retained earnings, not its bad debt expense or reserve account) when it had believed the account was uncollectible.

Respondent examined all of appellant's prior returns and found no evidence of the alleged opposite entry. Respondent then requested information which would substantiate

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appellant's oral statements regarding the mislabeling of the inventory adjustment and the prior year's opposite entry. No information supporting appellant's contentions was forthcoming. In the absence of such information, respondent issued the proposed assessment in question. Appellant's protest was denied and this appeal followed.

For purposes of this appeal, the gross income of a manufacturing business such as appellant's is determined by reducing the total sales by the cost of goods sold. (Cal. Admin. Code, tit. 18, reg. **24271(b)**, subd. **(1)**.) Cost of goods sold is determined by adding to the inventory at the beginning of the year merchandise purchased for **sale and** associated expenses and subtracting therefrom the inventory at the end of the year. (See Harry Hartley, 23 T.C. 353 (1954).) Taxpayers challenging respondent's action with respect to inventories bear the burden of presenting proof sufficient to overcome the presumption of correctness which attaches to respondent's determination. (Appeal of J. J. Newberry Co., Cal. St. Bd. of Equal., June 4, 1970; Appeal of Crisler Corporation, Cal. St. Bd. of Equal., Nov. 21, 1957.)

In this appeal it is uncontested that appellant's "inventory adjustment" served to reduce net income. In response to inquiries concerning the nature of the adjustment, appellant maintained that, in actuality, the amount represented the recovery of a bad debt. It is appellant's position that the adjustment, which served to reduce income in the appeal year, was proper because an opposite entry, which did not reduce income, was made in a prior period when the debt was believed to be uncollectible. However, no evidence to support appellant's assertions has been produced. No evidence pertaining to the date of the transaction or the name of the account has been offered. Furthermore, respondent was unable to locate any prior opposite entries during the course of its audit. Arbitrary adjustments, where not supported by the facts are not allowable. (See generally 2 Mertens, Law of Federal Income Tax, § 16.09, (1974 Revision).) In view of **appellant's** failure to provide any information in support of **its** position we must conclude that it has failed to satisfy its burden of proving that respondent's determination is incorrect. Accordingly, respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS **HEREBY** ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Airways Compressor Company, **Inc.**, against a proposed assessment of additional franchise tax in the amount of \$955.00 for the income year ended October 31, 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 25 day of September , 1979, by the State Board of Equalization.

Stella M. Burt, Chairman
James Brown, Member
Philip G. ..., Member
..., Member
George R. Kelly, Member